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KEYNOTE ADDRESS

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THE NEED TO REDUCE REGULATORY ARBITRAGE

The case for creating a financial “super regulator” does not rest on the existence of financial supermarkets but, rather, just the opposite.

We are living in a financial bazaar where different types of financial intermediaries offer us competing products and services to meet our needs for borrowing, saving and investment. While individual vendors may offer us a wider or narrower array of choices, because of the diversity of both the forms of intermediation and of the vendors providing these different forms, we need a system of financial regulation that will promote — not hinder — real competition among all of the vendors of financial services.

In these terms I think there is a compelling case for greater coherence in our rule writing process for financial services, perhaps even for a “super regulator.” But I draw a sharp distinction between financial *regulation* — rule writing — and financial *supervision*. Our biggest mistake is that we continue to lump these two together. The promise of Gramm-Leach-Bliley will *never* be fulfilled so long as we continue to muddle the distinction between rule writing for financial services, on the one hand, and the supervision of financial intermediaries, on the other.

A single federal rule writer, or rule writing process, would need to respect and nurture the existence of different forms of financial intermediation and, at the same time, encourage competition among both the forms and the firms that provide them.

A single rule writer would need to respect two principles: first, that like products and like services should receive a like regulatory treatment and, second, that distinct products and distinct services should receive distinct regulatory treatment.

The rule writer need only have the wisdom to know the difference.

Supervision — the hands on business of looking over the shoulders of the financial intermediaries — will and should remain divided among a number of different agencies and organizations, focused discretely on individual firms, products, and different policy objectives. We will and should have functional supervision and we will and should also have goal-oriented supervision. Somebody is going to supervise banks and somebody is going to supervise insurance companies and somebody is going to try to protect consumers and investors. I see very few, if any, benefits from rolling all of these different purposes and objectives into a “super supervisor.”

Having stated by my conclusions let me now explain my logic.

I am skeptical of the view that the future belongs to large conglomerates operating as financial “supermarkets.” Large financial firms do have some important advantages, among them greater potential for diversification. Diversification spreads risk and stabilizes earnings. Yet large firms must continuously work to achieve an effective diversification of their exposures and to avoid risk concentrations lurking inside seemingly diversified portfolios of assets.

Advances in information and communication technology offset some of the scale and diversification advantages that large institutions may have. Today, technology permits small firms to outsource many functions and thereby recapture some of the advantages previously associated only with economies of scale.

Thus, I expect that we will have a world in which nimble financial institutions of varying sizes, including both financial supermarkets and more focused financial firms, will compete with one another.

As a society, we have — and want to retain — different, competing forms of financial intermediation, whether based on charter, product, function, or other form. We can call them banking, insurance, or investment activities or products; we can call them credit intermediation, temporal intermediation and resource allocation; or we can call them making payments and pooling risks.

For my purpose today, it does not matter what typology you want to have in mind. We need only observe that we have different forms of financial intermediation and, as a society, we

want there to be a healthy competition among these forms and the firms that provide them.

For our society the objective is clear: we want progressive improvement in the efficiency with which we convert savings into investment. Both collectively and as individual savers and investors, we want the greatest efficiency possible in this process — minimizing the loss of savings, maximizing the investment. Efficiency in this process promotes the growth of our economy.

What process will create a progressive improvement in the efficiency with which savings are converted into investment?

The dynamic process begins with the *inefficiency* of financial markets which, through competition, tend toward efficiency. The economists' assumption about efficient markets is not helpful because it assumes away the important process of squeezing out inefficiencies. When individual financial intermediaries pursue a profit maximizing strategy in a competitive environment, society benefits from the increased efficiency with which savings are converted into investment.

As this process unfolds, as a rough proxy for improvements in the productivity of capital itself, we should expect to see the aggregate profits of financial intermediaries decline as a percentage of our savings and our investment. The profits of individual firms might grow and aggregate profits might grow in nominal terms, but the better outcome for society would be a decline in total financial intermediary profits as a share of total savings.

From the viewpoint of a particular franchise, this isn't always how financial firms, their lobbyists and even their supervisors tend to approach the subject.

The history of regulatory practice too frequently reflects a different assumption: that to ensure the stability of a given *form* of intermediation we should provide individual *firms* with stable and positive earnings, in part, by limiting the competition they face. I think this is misguided.

I take it as given that too much of our financial regulatory process is aimed at limiting rather than expanding effective competition. We have too much, rather than too little, regulatory arbitrage. Rules that expand competition are in the public interest. Rules that limit competition — either directly or by bestowing unique privileges on a narrow set of firms — are not in the public interest because they limit the forces that help us efficiently convert savings into investment.

In financial services this is not principally a function of “agency capture.” Individual firms do have incentives to limit competition and there may be some degree of agency capture. But in financial services a problem arises because the chartering regulatory authority has an incentive to promote the “soundness” of its particular form of intermediation by limiting the competition. Each chartering regulatory authority has just a single corner or piece of the total capital structure of financial intermediation and, thus, has an incentive to “protect” the revenue sources of its franchisees in order to assure their “soundness”.

We need to clarify the objectives of the rule writing authority, or the rule writing process, to ensure that it promotes rather than hinders competition among forms of intermediation. To do this, the rule-writing process must respect the different forms intermediation: products that are distinctly banking or distinctly insurance should receive distinct treatment, but for products overlapping industries, we need a set of like rules for like products.

This would ensure that rule writing not stand in the way of competition at the frontiers between intermediation forms and firms. Perhaps we should have single, federal financial rule writer to serve this objective. It might also be plausible to maintain separate agencies charged with rule writing, but accountable to these standards through an appellate process. There could also be a rule writing committee, with binding authority, composed of distinct supervisory agencies. Regardless of what mechanism evolves, our objective must be greater coherence in rule writing to promote effective competition.

One thing I am certain of is that we will not put all of federal financial supervision and regulation into a single agency, nor should we. Concentrating so much regulatory and supervisory power in one place is simply not within the bounds of our political tradition. More importantly, financial *supervision* needs to be focused on specific lines of business and sets of risks.

The existence of financial supermarkets and conglomerates does pose a challenge for supervisors. Somebody needs to focus on risks at the holding company level while others need to focus on risks in particular business lines. But it does not follow that we need a single federal financial supervisor.

Financial supervision almost invariably originates with a desire to avoid or mitigate bad outcomes — losses to depositors, to

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investors, or to consumers. As such, supervision tends to begin by focusing on the “negative tail” outcomes — making sure that supervised entities avoid the most harmful practices. The more effective way to avoid negative tail outcomes, however, is to focus on improving median and mode performance and to encourage “positive tail” outcomes.

Indeed, the only compelling case that I can see for financial supervision is as a means of more rapidly disseminating best practice among firms whom we wish to see fail less frequently than would otherwise be the case. To redistribute best practices, the supervisor needs to know what best practice is and, therefore, needs to know something quite specific about the business of the firms he or she supervises. In addition, to be effective, supervision needs to be directed at the level of risk-bearing entities and, within financial holding company structures, there are multiple levels of risk-bearing entities.

Pausing just a moment to consider all the different forms of intermediation and businesses that deliver these services — from credit cards to mortgages to mutual funds to annuities — and to the different corporate forms that can provide their services, will give us sufficient insight, I think, to recognize what little sense it would make to roll all of financial supervision into a single agency. We may, at present, have more federal financial supervisors than is optimal. But I am certain that a single federal financial supervisor would not be optimal either.

The distinction I am drawing between rule writing and supervision is not new. Indeed, for almost thirty years we have been stumbling toward recognition that we want a common set of rules for financial intermediaries while, at the same time, we want to maintain discrete supervisors for different types of financial firms.

Starting in the early 1970s, in the wake of the Herstatt crisis, the Basel Committee on Banking Supervision began to write common rules, eventually leading to the more than twenty-year effort to write common capital rules for internationally active banks. Also internationally, in recent years there have been increasingly frequent joint efforts among bank, securities and insurance regulators.

Here in the United States, the President’s Working Group on Financial Markets, the FFIEC, and numerous congressionally mandated joint studies over the years all reflect efforts of one kind or another to harmonize regulatory practices. The

Gramm-Leach-Bliley Act's functional regulation provisions and rulemaking process for authorizing new activities of financial holding companies have also represented steps in this direction.

I think we should stop dragging our feet and accept what we have long been seeking in a piecemeal, erratic fashion.

A more coherent, unified rule writing process would properly recognize different modes of intermediation while encouraging competition among them. Retarding this process is not in the public interest and will only serve to decrease the potential efficiency of converting our savings into investment. The supervisory process, however, will and should remain diverse, aimed at each risk-bearing entity within financial firms and at different policy objectives.

If we continue to muddle along, the promise of the Gramm-Leach-Bliley Act to adapt our financial laws to the realities of the 21st century will never be fulfilled.